Rabobank

Country report **SAUDI ARABIA**

Summary

Saudi Arabia is a prosperous country due to an abundance of hydrocarbon resources. The country was hardly affected by contagion from the Arab Spring protests, due to substantial government hand-outs and wage increases. Even so, the ruling Al Saud family will remain wary of the potential for popular discontent, given widespread perceptions of corruption, vast inequalities in wealth and high youth unemployment. Succession risks are a threat to political stability in the medium run. The economy needs to diversify away from the hydrocarbon sector in the long-term. In the short-term, sizeable hydrocarbon export revenues over the years have resulted in an extremely healthy external position. Public finances are sound, but could come under pressure if the government feels forced to implement more costly social spending packages.

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Saudi Arabia

National facts	
Type of government	Absolute monarchy
Capital	Riyadh
Surface area (thousand sq km)	2,150
Population (millions)	28.0
Main languages	Arabic
Main religions	Muslim (100%)
Head of State (president)	King Abdallah bin Abdel--Aziz al Saud
Head of Government (PM)	Crown Prince Abdallah bin Abdel-Aziz al-Saud
Monetary unit (code)	Riyal (SR)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	597	0.86
Nominal GDP at PPP	687	0.87
Export value of goods and services	376	1.71
IMF quotum (in mln SDR)	6986	3.21
Economic structure	*2011*	*5-year av.*
Real GDP growth	7.0	2.9
Agriculture (% of GDP)	2	3
Industry (% of GDP)	67	64
Services (% of GDP)	31	33
Standards of living	*USD*	*% world av.*
Nominal GDP per head	21317	197
Nominal GDP per head at PPP	24541	197
Real GDP per head	13915	170

Social and governance indicators	rank / total
Human Development Index (rank)	56 / 187
Ease of doing business (rank)	22 / 185
Economic freedom index (rank)	74 / 179
Corruption perceptions index (rank)	57 / 183
Press freedom index (rank)	158 / 178
Gini index (income distribution)	n.a.
Population below $1 per day (PPP)	n.a.

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Japan	14	China	13
China	14	US	12
US	13	Japan	6
South Korea	10	India	5
Main export products (%)			
Crude petroleum			78
Refined products			11
Main import products (%)			
Machinery & equipment			38
Food, beverages and tobacco			14
Chemicals and metal products			8
Openness of the economy			
Export value of G&S (% of GDP)			63
Import value of G&S (% of GDP)			33
Inward FDI (% of GDP)			2.7

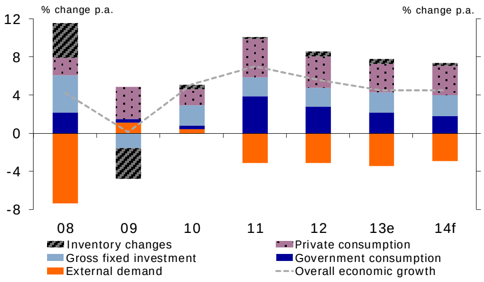
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Saudi Arabia has an oil-based economy with strong government controls over major economic activities. The petroleum sector accounts for roughly 80% of budget revenues, 45% of GDP and 90% of export earnings. The country possesses about 25% of the world's proven petroleum reserves, ranks as the world's largest exporter of petroleum and plays a leading role in OPEC as ‘swing producer’ with excess production capacity and huge financial reserves to survive oil revenue declines. Saudi Arabia is commonly referred to as the central bank of oil, since it has the market power to influence global oil prices, which is the basis for its international clout. Saudi Arabia is making slow progress in encouraging the growth of the private sector in order to diversify its economy and to employ more Saudi nationals, since less than 5% of the workforce is employed in the state-dominated oil-related businesses. Diversification efforts are focusing on power generation (including nuclear), telecommunications, natural gas exploration and petrochemical refineries. The government has begun establishing six "economic cities" in different regions of the country to promote private sector activity and economic diversification. These massive infrastructural works are valued at USD 385bn for the next five years. On the back of this substantial government spending and investment, the economy is estimated to grow 5.6% in 2012 and forecast to grow 4.5% in 2013. The expected slowdown in 2013 is due to an anticipated prolonged slowdown of the world economy. Saudi Arabia's oil production is expected to be scaled back next year amid weaker external demand and falling oil prices. The country's main export markets and largest petroleum off-takers are Japan, China, South Korea and the US. A more sluggish than expected US economy and possible hard landing in China are significant downside risks to our growth forecast.

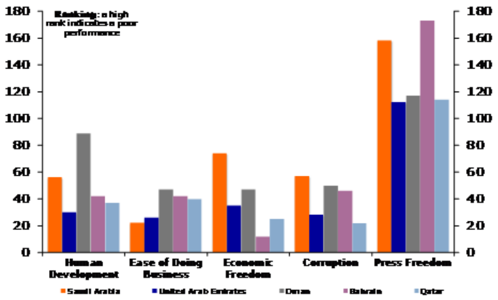
The banking sector is sound, after the authorities made direct capital injections into banks and explicitly guaranteed bank deposits in 2008 and 2009 during the nadir of the global financial crisis. The large financial reserves of the Saudi authorities lend credibility to the support for the banking sector. Overall bank sector credit growth was moderate at 8.2% yoy in 2011. Domestic lending conditions have improved due to strengthening domestic activity in 2012. Since this is anticipated to continue, our outlook for 2013 is positive. The banking sector has no significant exposure on sovereign debt of Europe's peripheral countries.

Figure 1: Growth performance



Source: EIU

Figure 2: Social & governance indicators



Source: See factsheet

Political and social situation

Saudi Arabia has no political parties, its monarchy is hereditary and the political decision-making in the country is dominated by the al-Saud clan. Royal decrees of 2003 and 2006 promised a form of election of a next king, a broadening of the electorate and even elections of local and provincial executives, but, so far, no such elections have been held or even announced. Councillors are elected by the monarch in what is basically a hierarchical feudal political system.
Similarly, the legal system is far from modern and is largely based on Islamist sharia law, although several secular laws have been introduced and commercial disputes are handled by special non-religious committees. In line with the belief in Islamic religious supremacy, the country has not committed itself to accept any jurisdiction of the International Court of Justice.
Succession risks are a threat to political stability in the future, which was highlighted by the recent deaths of two Crown Princes in a timeframe of only eight months. Moreover, even after King Abdullah bin Abdel-Aziz al-Saud would be succeeded by someone from the next generation succession risks would remain, as the princes next in line are very old (60-80 years) and unlikely to remain in power very long. As the next generation is eager to step into positions of greater responsibility, future political transitions will likely be more troublesome.

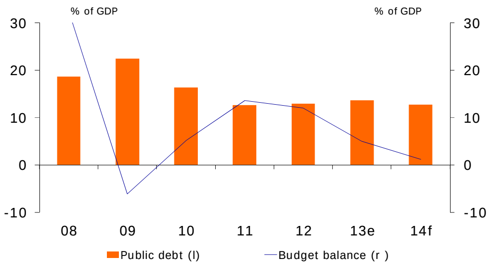
The Al Saud family will remain wary of the potential for popular discontent, given widespread perceptions of corruption, vast inequalities in wealth and high youth unemployment. With this in mind, King Abdullah bin Abdel-Aziz al-Saud announced a raft of welfare hand-outs and public-sector wage increases in early 2011, followed by another social spending package in 2012. In addition, he has also leaned towards social reform. For instance, he has introduced measures to promote women's rights, while simultaneously distancing himself from hard-line conservative clerics and restraining the activities of the religious police. However, neither he nor any of his likely successors has shown any inclination to reduce the Al Saud's domination over the organs of state. We believe that small groups, who are frustrated at the lack of political openness, are likely to mobilize in protest against specific issues. In this respect, we note that that there has already been a proliferation of online petitions and protests in the Eastern Province. While we do not expect an escalation given the government's response, protests are likely to continue to cause social unrest in the short-term.

Saudi Arabia foreign policy is not a very active one and is mainly focused on promoting regional stability. As demonstrated by its decision to send troops into Bahrain in March last year (after an invitation from the Bahraini king), Saudi Arabia will take an active role in countries it deems to be within its sphere of interest, even if this occasionally runs counter to the wishes of the US, Saudi Arabia's most important strategic partner. Saudi Arabia remains very vigilant on a militant threat to the country from neighboring Yemen. The presence of Al-Qaeda militant activity is a particular concern. However, the Saudi forces are considered highly capable of fending off the militant threat and the oil installations are very well protected. Saudi Arabia will continue to compete for regional influence with its arch-rival Iran, whose nuclear capabilities remain a threat to the country's security.

Economic policy
Public finances are in healthy shape; public debt is estimated at USD 13.8bn at end 2012 and the budget will show a surplus of 12% of GDP in 2012. We expect this surplus to decline in 2013 to 5% of GDP, as a large part of the planned infrastructure spending package announced in 2011 will be implemented then. However, the major vulnerability of the public finances on the revenue side is the reliance of the government on hydrocarbon income. Although, as the government has accumulated large savings, any oil price fall would need to be steep and prolonged to have a serious impact. The breakeven oil price for the government budget is a prospective USD 72 per barrel in 2012, based on an assumed oil production of 9.35m barrels per day (bpd), compared to USD 71 per barrel in 2011. Market prices year to date have hovered markedly above the breakeven oil price, which has been a boon for Saudi Arabia's 2012 budget. The country's oil production surpassed 10m bpd in November 2011, thus reaching the highest monthly output since 1980. What is more, Saudi Arabia still has 2.5m bpd of spare capacity. We believe that it can boost oil production to 11.8m bpd quickly if required, but reaching maximum capacity of 12.5mbd would take some time. The oil minister Ali al Naimi sought to reassure oil markets in March by pledging to increase supply if demand existed. For every extra 0.1mbd that is exported over a year, export earnings would rise by USD 4bn, most of which would go straight to the government budget.

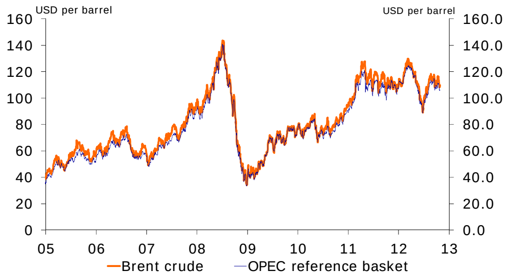
Meanwhile, over the medium term, a growing population will put pressure on spending. The population is forecast to grow to 30m in 2017, up from 28m in 2012. The government may feel pressured to create even more public sector employment for the growing population. There is no data available for 2011 or 2012 yet on hiring by the public sector, although the government pledged to create 60,000 new jobs in the interior ministry. In 2010, the latest year with actual data, the public sector payroll increased by 2.1% year on year, or by 17,500 employees. A substantial part of the fiscal expenditures are used to expand the economic base into the sectors of power generation (including nuclear), telecommunications, natural gas exploration and petrochemical refineries. The government has outlined this strategy in its ninth five year development plan of USD 385bn, which is mostly aimed at drawing in private investment to fuel the expansion of the non-oil sector.

Figure 3: Fiscal balance



Source: EIU

Figure 4: Oil prices

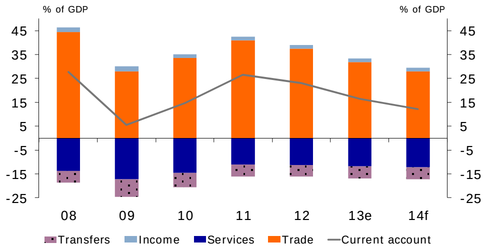


Source: EIU

Additional to this plan are the social support packages of around USD 150-160bn, which were introduced in 2011 and the implementation of these packages continue in 2012. These are aimed to provide better social security conditions and reduce youth employment in order to stem any social unrest. Reducing youth unemployment has become a policy priority for the government for both economic and social reasons. The unemployment rate is 10.5%, and among those aged 20-24 it is 42%. Around 300,000 young people enter the labor force every year, including a growing number of women. The government has introduced several labor market reforms. It introduced an unemployment benefit safety net and plans to reform labor market regulation to make it easier to fire Saudis, which would make it more attractive for employers to hire them. Foreign workers will also be given the right to change jobs, which will discourage employers from hoarding foreign labor. This could result in higher wages for foreign workers, whichshould encourage the private sector to hire more Saudis. However, skills mismatches, a preference for public sector jobs and the much lower reservation wages of foreign labor compared with Saudis, combined with the lobbying power of the private sector, are formidable barriers to creating jobs for Saudis. Regulations can be by-passed, for example by companies using subcontracted labor. Low-paid jobs in domestic service and construction will continue to be dominated by expatriate labor.

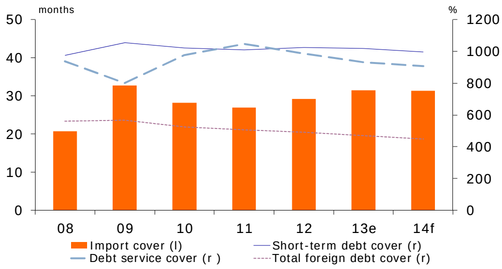
The domestic currency, riyal, is pegged nominally to the USD at 3.75 SAR/USD. While this peg has served as a credible anchor for monetary policy and the economy as a whole, it makes Saudi Arabia dependent on US monetary policy. Monetary policy is likely to remain accommodative to boost economic growth and lending. Inflation is expected to remain manageable at 4.6% in 2012. Inflation has been spurred to a large extent by rising rents in 1H2012, as supply shortages persisted. But since new properties projects have been completed recently, inflation eased in August and September, a process which is likely to continue throughout 2013. An upside risk to this forecast are higher wheat prices on the back of the drought of the US. The country’s central bank, the Saudi Arabian Monetary Authority (SAMA), is likely to wait for a cue from the Federal Reserve before raising rates.

Figure 5: Current account



Source: EIU

Figure 6: External liquidity



Source: EIU

Balance of Payments

Saudi Arabia will record a large 23.1% of GDP surplus on the current account in 2012. We expect Saudi Arabia to record large but narrowing current-account surpluses, as strong domestic demand is boosting imports. High international oil prices, combined with elevated oil production and surging petrochemical exports, should keep the trade balance comfortably in surplus nevertheless. These surpluses will offset persistent deficits on the services and current transfers accounts. Income from investments abroad was sustained through the global economic slowdown. We expect net direct investment flows via the financial account to remain sizeable and grow in the coming years, tied to the government's policy to attract FDI to fund the private non-oil sector expansion. The level of official FX-reserves will increase to USD 626bn at end-2012. Overall, the balance of payments is in very healthy shape.

External position

Saudi Arabia is a net creditor country and has a very healthy external position. Total foreign debt is moderate at 20% of GDP, but the portion of short-term debt is rather high at 47%.
With sizeable FX levels of USD 626bn, the liquidity position is extremely comfortable. The import cover amounts to 47 months and debt service cover to 987%, both indicate an excellent ability to honor all existing short and longer term debt obligations.

Saudi Arabia

Selection of economic indicators	2008	2009	2010	2011	2012e	2013f	2014f
Key country risk indicators							
GDP (% real change pa)	4.2	0.1	5.1	7.0	5.6	4.5	4.5
Consumer prices (average % change pa)	9.9	5.1	5.4	5.0	4.6	4.5	3.3
Current account balance (% of GDP)	27.8	5.6	14.6	26.5	23.1	16.5	12.1
Total foreign exchange reserves (m USD)	442249	409694	444722	540677	626375	668260	701739
Economic growth							
GDP (% real change pa)	4.2	0.1	5.1	7.0	5.6	4.5	4.5
Gross fixed investment (% real change pa)	12.6	-4.6	6.6	6.2	6.3	6.4	6.6
Private consumption (real % change pa)	3.5	6.7	3.2	7.5	6.2	5.7	5.8
Government consumption (% real change pa)	6.0	1.0	1.0	11.2	7.7	6.0	4.8
Exports of G&S (% real change pa)	-4.2	-7.3	8.3	7.3	4.3	-0.7	0.5
Imports of G&S (% real change pa)	9.7	-6.3	4.2	10.0	7.9	5.3	5.1
Economic policy							
Budget balance (% of GDP)	32.5	-6.1	5.1	13.6	12.0	5.0	1.2
Public debt (% of GDP)	19	22	16	13	13	14	13
M2 growth (% change pa)	18	11	5	13	10	10	10
Consumer prices (average % change pa)	9.9	5.1	5.4	5.0	4.6	4.5	3.3
Exchange rate LCU to USD (average)	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Recorded unemployment (%)	9.8	10.5	10.8	10.9	10.7	10.5	10.4
Balance of payments (m USD)							
Current account balance	132315	20953	66751	158492	149993	108545	82666
Trade balance	212026	105229	153717	244712	244647	210249	190709
Export value of goods	313480	192307	251149	364735	381473	357338	348277
Import value of goods	101454	87078	97432	120023	136826	147088	157568
Services balance	-65864	-65242	-66089	-66536	-72717	-78418	-83997
Income balance	9165	8639	7044	9668	9838	10077	10319
Transfer balance	-23012	-27673	-27921	-29352	-31775	-33363	-34364
Net direct investment flows	34653	29923	24198	12958	13958	15974	17378
Net portfolio investment flows	-3545	-20043	-18794	-30857	-36184	-29740	-14300
Net debt flows	9997	-6005	12612	22056	20302	15410	13811
Other capital flows (negative is flight)	-36465	-57382	-49739	-66694	-62341	-68326	-66201
Change in international reserves	136955	-32555	35028	95955	85728	41862	33354
External position (m USD)							
Total foreign debt	79003	72398	85009	107066	127368	142778	156589
Short-term debt	45329	38906	43532	53626	61133	65718	70401
Total debt service due, incl. short-term debt	47123	51258	45557	51730	63471	71869	77475
Total foreign exchange reserves	442249	409694	444722	540677	626375	668260	701739
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	44.5	27.9	33.7	41.0	37.6	31.9	28.0
Current account balance (% of GDP)	27.8	5.6	14.6	26.5	23.1	16.5	12.1
Inward FDI (% of GDP)	8.0	8.5	6.2	2.7	2.6	2.8	2.9
Foreign debt (% of GDP)	17	19	19	18	20	22	23
Foreign debt (% of XGSIT)	23	33	30	27	31	36	41
Debt service ratio (% of XGSIT)	14	23	16	13	15	18	20
Interest service ratio incl. arrears (% of XGSIT)	1	2	1	1	1	1	2
FX-reserves import cover (months)	36.1	60.9	50.5	44.5	47.4	51.1	50.9
FX-reserves debt service cover (%)	939	799	976	1045	987	930	906
Liquidity ratio	270	284	293	314	313	309	299

Source: EIU